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Date: March 31, 2010

Taxpayer =  
R Company =  
Group =  
State =  
W Corporation =  
X Corporation =  
Y Corporation =  
Tax Agreement =  
Assignment Agreement =  
Prepayment Agreement =  
Date 1 =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
\$c=  
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p%=  
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This letter is in response to your letter requesting a ruling whether Taxpayer realized cancellation of indebtedness income under § 61(a)(12) of the Internal Revenue Code when it prepaid \$d to settle a portion of its obligations under the Tax Agreement.

## FACTS

### *Background*

During Date 1, W Corporation, a State corporation, was the common parent of a federal consolidated group. X Corporation was a wholly-owned indirect subsidiary of W Corporation. R Company, a State limited liability company, was a wholly-owned subsidiary of X Corporation and was a disregarded entity treated as a division of X Corporation for federal income tax purposes.

### *Conversion*

On Date 2, R Company was converted into Taxpayer pursuant to State laws and all of R Company's outstanding membership interests were converted into shares of common stock and preferred stock of Taxpayer (Conversion). As a result of the Conversion, Taxpayer acquired and directly owned all of the outstanding stock of three different corporations (Subsidiaries) as well as outstanding membership interests of a limited liability company. Taxpayer and its Subsidiaries comprise the Group and file a consolidated return for federal income tax purposes. Taxpayer uses the accrual method of accounting and files its returns on a calendar year basis.

Taxpayer represents that the Conversion was a taxable exchange under § 1001 and a qualified stock purchase under §338(d)(3) by Taxpayer with respect to the Subsidiaries. Following the Conversion, W Corporation and Taxpayer made § 338(h)(10) elections with respect to two Subsidiaries and Taxpayer made a § 338(g) election with respect to the third Subsidiary. The tax basis in the Taxpayer's assets, and assets held by each of Taxpayer's subsidiaries, was stepped up to fair-market value.

In exchange for Taxpayer's assets, X Corporation received (i) the common and preferred stock of Taxpayer, (ii) the assumption by Taxpayer of the liabilities of R Company immediately prior to the Conversion, (iii) \$c, and (iv) the right to receive certain contingent payments that were to be made to W corporation under the Tax Agreement dated Date 3, among W Corporation, X Corporation, and Taxpayer.

### *Tax Agreement*

Pursuant to Tax Agreement, Taxpayer was required to pay to W Corporation p% of the excess, if any, of the Hypothetical Tax Liability (HTL) Taxpayer would have incurred using the tax basis of the assets as recorded on W Corporation's tax books and records immediately prior to the Conversion, over Taxpayer's actual tax liability using the stepped-up basis in the assets resulting from the Conversion and § 338 elections (Tax Benefit Payments). The HTL was also computed by (i) assuming that any losses or tax attributes would be carried forward to future taxable years and (ii) excluding deductions for imputed interest (for example, interest under §§ 483, 1272, and 1274). The taxes to

which the agreement applied were all taxes and other assessments imposed by the Internal Revenue Service and any other state, local, foreign or other governmental entity responsible for the administration of taxes. The Tax Agreement was based on the actual tax rates in effect from time to time in the jurisdictions that Taxpayer was subject to tax. The Tax Agreement also contemplated that any Tax Benefit Payment made to W Corporation would further increase the adjusted basis of the assets and thus, further increase the potential tax benefit. Taxpayer represents that it did not have any basis in the assets as a result of incurring its obligation under the Tax Agreement. Instead, Taxpayer receives basis when a Tax Benefit Payment becomes fixed and is paid.

Taxpayer was required to make payments under the Tax Agreement on the due date of estimated taxes under § 6655 or any comparable provision of state or local law. The payments were also subject to a true-up after Taxpayer filed its income tax returns for the year. In addition, Taxpayer's liability for the payments was recomputed if there was a change in Taxpayer's tax liability as a result of a final determination under § 1313(a) or a similar provision of state, local, or foreign law.

The purpose of the Tax Benefit Payments was to allow W Corporation to share any tax benefit Taxpayer actually realized over time as a result of the stepped-up tax basis in the assets. The Taxpayer represents that the obligation to make the Tax Benefit Payments is indebtedness for purposes of § 61(a)(12).

#### *Assignment*

The Tax Agreement permitted W Corporation to assign some of its rights, interest or entitlements and obligations under the Tax Agreement to any W Corporation affiliate without the permission of Taxpayer. On Date 4, W Corporation, Y Corporation and certain other corporations entered into Assignment Agreement, under which W Corporation assigned its right to q% of the Tax Benefit Payments to Y Corporation and Y Corporation assumed q% of W Corporation's liabilities and obligations under the Tax Agreement. Taxpayer continued to make Tax Benefit Payments to W Corporation following the execution of Assignment Agreement and, W Corporation transferred q% of these payments to Y Corporation.

#### *Prepayment Agreement*

On Date 5, Taxpayer and Y Corporation executed the Prepayment Agreement because Y Corporation preferred a lump-sum payment instead of future contingent payments. Pursuant to the Prepayment Agreement, Taxpayer agreed to pay Y Corporation \$d (less certain expenses) in full satisfaction of Taxpayer's remaining obligations to make Tax Benefit Payments under Tax Agreement to W Corporation for the portion W Corporation assigned to Y Corporation. This amount represents the portion of the rights assigned by W Corporation to Y Corporation.

## LAW AND ANALYSIS

Under § 61, gross income includes all income from whatever source derived, including income from discharge of indebtedness (under §61(a)(12)).

In *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), the Supreme Court held that a taxpayer that purchased its own bonds at a discount in the open market realized income to the extent of the gain realized as a result of the discount. The Supreme Court reasoned that the debt reduction resulted in a “freeing of assets” that were previously subject to obligation of the bonds, which was clearly an accession to the taxpayer’s wealth, and therefore income to the taxpayer.

By contrast in *Corporacion de Ventas de Salitre Y Yoda de Chile v. Commissioner*, 130 F.2d. 141 (2d Cir. 1942), the court held that the taxpayer’s purchase at a discount of its own bonds that were payable only out of a percentage of future corporate profits did not give rise to income. The court explained that the treatment of the prepayment of contingent debentures differed from the treatment described in *Kirby Lumber* because the contingent nature of the debt made it impossible to determine whether or not the transaction was immediately profitable. *Id.* at 143.

Taxpayer’s liability under the Tax Agreement is analogous to the taxpayer’s liability in *Corporacion de Ventas* because it was contingent upon its future earnings. In addition, Taxpayer’s liability was contingent upon future tax rates in the jurisdictions in which Taxpayer was subject to tax and, ultimately, Taxpayer’s actual realization of tax benefits from the stepped-up basis in the assets. Therefore, because Taxpayer’s obligation under the Tax Agreement was a contingent obligation, Taxpayer does not realize any cancellation of indebtedness income by prepaying \$d to satisfy its remaining obligation under the Tax Agreement of the portion of the payments assigned to Y Corporation.

## CONCLUSION

Based on Taxpayer’s representations and submission, we conclude that Taxpayer does not realize any cancellation of indebtedness income because of its prepayment of \$d to Y Corporation, in satisfaction of its remaining obligation to make Tax Benefit Payments to W Corporation for the portion of the rights Y Corporation received under the Assignment Agreement.

Except as expressly provided in the preceding paragraph, we do not express or imply an opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. For example, this ruling does not address the effect of § 483 on any of the Tax Benefit Payments, including the prepayment of \$d.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Income Tax & Accounting)